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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, SEPTEMBER 17, 1999

JOINT PETITION OF

DOMINION RESOURCES, INC.
and
CONSOLIDATED NATURAL GAS COMPANY

CASE NO. PUA990020

For approval of agreement and
plan of merger under Chapter 5
of Title 56 of the Code of Virginia

ORDER APPROVING MERGER

On April 5, 1999, Dominion Resources, Inc. ("DRI"), and Consolidated Natural Gas Company ("CNG") (collectively, the "Petitioners") filed a joint petition requesting approval, pursuant to § 56-88.1 of the Code of Virginia, of a proposed transaction that would result in CNG becoming a wholly owned subsidiary of DRI ("the merger"). On May 6, 1999, the Petitioners provided additional information that clarified and amended the joint petition. On May 21, 1999, the Petitioners filed an Amended and Restated Agreement and Plan of Merger.

The joint petition was deemed to be complete for purposes of our consideration on May 21, 1999. The Petitioners agreed that, until the May 21 filing, their application had not been complete.¹ The Commission entered an Order for Notice and

¹ The importance of this determination is that Code § 56-88.1 establishes time limits within which the Commission must act upon a "completed application." The Commission has sixty days, which may be extended if

Comment and Extending Time for Review, also on May 21, 1999. In that Order we required the Petitioners to publish notice to the public of their application, and afforded interested parties the opportunity to comment on or request hearing on the joint petition. Because of the complex nature of the proposed transaction, we extended the date for completion of our review to November 17, 1999, the full statutory period permitted.

Comments on or requests for hearing were to be filed on or before July 13, 1999. On that date three parties filed comments or requests for hearing. The Virginia Independent Power Producers, Inc. ("VIPP"), filed comments and requested a hearing. Old Dominion Electric Cooperative and the Virginia, Maryland & Delaware Association of Electric Cooperatives (collectively, the "Coops") filed joint comments and requested a hearing. The Virginia Committee for Fair Utility Rates (the "Committee") filed comments and requested the opportunity to participate in a hearing if one were to be held. On July 13, 1999, the Staff filed a motion requesting an extension of the time for the filing of its report from August 6, 1999, to September 8, 1999.

On August 9, 1999, the Staff filed a Motion for Consideration of Stipulation ("Motion"), together with a Stipulation entered into by and among the Staff, DRI, CNG,

necessary for an additional 120 days, to complete its review under this statute. Applications not acted upon within this statutory limit are deemed to be approved.

Virginia Electric and Power Company ("Virginia Power") and Virginia Natural Gas Company ("VNG"). The Stipulation purported to resolve all issues between and among the stipulating parties, and would, as its most prominent provision, require the Petitioners to divest ownership of VNG as a condition of, and following approval of, their merger.

On August 10, 1999, the Commission entered its Order on Motion for Consideration of Stipulation. That Order required the Staff and the Petitioners to address the merits of the Stipulation in testimony to be filed on September 8, 1999, and permitted any other interested party to comment as well.

In response, VIPP and the Coops filed formal notice of their withdrawal from these proceedings. VIPP, by letter of counsel filed August 19, 1999, notified the Commission of its withdrawal of its Notice of Intent to File Comments, its Request for Hearing, and its Notice of Protest. The Coops filed, on August 17, 1999, their Motion to Withdraw Comments, Notice of Protest and Interrogatories. In light of the actions taken in this Order, that Motion will be granted. On August 20, 1999, the Committee filed notice of its intent not to file testimony in the proceeding. By earlier letter, dated August 6, 1999, the City of Richmond signified its intent to withdraw in all respects from the case.

Therefore, each of the parties that had filed a notice of protest or requested a hearing in this matter has withdrawn from

further participation and has withdrawn its request for hearing. The Committee did not request a hearing, but only asked for permission to participate in a hearing should the Commission deem one necessary.

In addition to the Notices of Protest filed by the corporate and collective parties mentioned above, two Virginia citizens, E. Dale Perry and Joan W. Perry, also filed a request for a hearing. The Perrys' letter, dated June 8, 1999, indicated their opposition "to a return to the past practice of the power company owning the gas company in a Virginia operation. We do not feel this is good for the citizens of Virginia and feel a hearing to spell out every detail and control measure should be required."

We find that the Stipulation answers the Perrys' essential opposition to the merger, in that the practice opposed by the Perrys will not recur: the gas company will be divested, so there will be no combined Virginia operation. In light of the filing of the Stipulation and the events that have occurred since, the Commission does not find a hearing to be necessary.

On September 8, 1999, the Staff filed the report of its investigation of the application ("Report"). The Commission's Division of Public Utility Accounting expressed concerns over the effects of DRI becoming a registered holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"), subject to regulatory requirements of the Securities and

Exchange Commission ("SEC"), to the extent that that agency's policies differ from those of the Commission. The Stipulation proposes measures to deal with this concern. All parties agree that the Commission should not be preempted from enforcing its requirements and that the Commission's authority with respect to Virginia Power and VNG should continue after the merger in the same manner as before.

We recognize that Petitioners, VNG and Virginia Power have agreed in the Stipulation to measures regarded as necessary to preserve our jurisdiction. We regard this agreement as indicating the parties' good-faith intention to maintain state, rather than federal, regulation over the activities that are subject to the Stipulation. By certain clarifying measures ordered herein, explained below, we will strengthen the means of carrying out that intention.

The Commission's Division of Economics and Finance had concerns about the potential effects of the merger on the capital costs of the companies, particularly the possibility that CNG's capital costs would increase, thus leading to higher rates for VNG. These concerns are mitigated by the agreed-upon disposition of VNG and the freeze on VNG's rates until such divestiture occurs.

The Commission Staff retained a consulting economist, Dr. Robert A. Sinclair, of J.W. Wilson & Associates, in Washington, D.C., to review market power issues arising from the proposed

merger. Dr. Sinclair's report is filed as part of the Staff Report herein.

In his report, Dr. Sinclair performed a horizontal market power analysis, comprising a concentration analysis and a review of other factors affecting market power, and evaluated several potential vertical market power concerns. Based upon his analyses, Dr. Sinclair concluded that, in the absence of the Stipulation, it would be advisable to disallow the merger because of its potential adverse effect on competition. However, he concluded:

The Stipulation entered into by the Staff, the Petitioners, Virginia Power, and VNG represents a major initiative that would greatly relieve both the horizontal market power problems and the vertical market power problems. The primary competitive concerns relate to (1) consolidation of natural gas and electricity supply; and (2) the merged entity's ability to control natural gas supply to new electric power generation facilities. The Stipulation largely addresses these issues by requiring divestiture of VNG's distribution and pipeline facilities.

(Staff Report, Part C, page iii.)

The Petitioners filed their Motion Requesting Approval of Joint Petition, together with the testimony of James L. Trueheart, Senior Vice-President and Controller of DRI, on September 8, 1999. The motion asserts that all opposition to the proposed merger has been withdrawn and asserts that the Stipulation and the testimony of Mr. Trueheart constitute a

sufficient record for the entry of an order approving the merger, without the need for public hearings on the matter.

Mr. Trueheart states that the merger meets the statutory standard established by Va. Code § 56-90, in that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized" by the merger. The testimony notes that the Stipulation freezes VNG's rates until that company can be divested; and that Virginia Power's rates were frozen both by the terms of its own rate stipulation, approved by us in Case Nos. PUE960036 and PUE960296,² and by the enactment of the Virginia Electric Utility Restructuring Act ("Restructuring Act") by the 1999 session of the Virginia General Assembly.³

Mr. Trueheart further states that Virginia Power will continue to be subject to "the Commission's ratemaking jurisdiction as provided in the Restructuring Act."⁴ He also testifies that the merger will not change the regulation of VNG or Virginia Power.

The Petitioners acknowledge that there will be several additional filings requiring Commission approval under the

² Virginia Electric and Power Company, 1995 Annual Informational Filing and Commonwealth of Virginia ex. rel State Corporation Commission Ex Parte: Investigation of Electric Utility Industry Restructuring - Virginia Electric and Power Company, Case Nos. PUC960036 and PUE960296, 1998 S.C.C. Ann. Rep. 322 (Final Order, August 7, 1998).

³ Section 56-576 et seq. of the Code of Virginia.

⁴ Testimony at 14.

Utility Affiliates Act⁵ following their merger and that the Commission must approve the proposed sale of VNG. Importantly, the testimony recites that even the Petitioners' federal registration "as public utility holding companies will not impact [the] Commission's ratemaking authority."⁶

NOW THE COMMISSION, upon consideration of the Joint Petition, the applicable statutes and rules, the record developed herein, including the Staff Report, the Trueheart testimony and all comments filed herein, is of the opinion and finds that the Stipulation should be accepted, and the requested acquisition should be approved subject to conditions set forth herein.

Considerable merger and acquisition activity has occurred within both the electric and gas industries, as reported in the press, including an increasing number of cross-industry combinations such as this one. The companies subject to these corporate marriages are seeking to position themselves favorably for what they see as the approaching "convergence" in the energy supply business. DRI and CNG cite this convergence as a central premise of their planned combination.

We would be unable to approve the proposed merger unless we were satisfied that adequate service to the public at just and reasonable rates would not be "impaired or jeopardized" by it.

⁵ Section 56-76 et seq. of the Code of Virginia.

⁶ Testimony at 16.

The Petitioners, VNG, Virginia Power and the Staff regard the Stipulation as providing a basis for that assurance. So do we. We find within it, as we noted above, an expression of the parties' acknowledgement that: (1) the services provided by VNG and Virginia Power are "adequate," (2) the rates approved by us are "just and reasonable," and (3) we should make certain that these standards continue in effect. In order to preserve the Commonwealth's ability to assure that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized," we will condition approval of the merger as set out below.

Divestiture of VNG

The agreement of the Petitioners to divest ownership of VNG constitutes one of the most important of the undertakings set out in the Stipulation. Clearly, this agreement was crucial to obtaining the Staff's assent to the Stipulation, given the testimony of Dr. Sinclair alluded to above. We agree that without the freeing up of VNG and the pipeline facilities it operates within Virginia Power's service territory, the merger could be detrimental to the development of effective retail choice for electricity in the Commonwealth.

We have been directed by the General Assembly to implement the provisions of the Restructuring Act, bringing life to the legislature's vision of a competitive market for electricity generation in the Commonwealth. A robust and vibrant market,

bringing those willing and able to sell a variety of products to those ready to purchase them, will help ensure the preservation of adequate service to customers at just and reasonable rates and thereby provide protection for the public interest. Until that day arrives, however, the responsibility remains ours to assure continued quality of service and preservation of just and reasonable rates as we consider applications such as this one.

The Restructuring Act directs us to take measures necessary to bring that market into existence. The General Assembly provided tools necessary to deal with obstacles to the fruition of this market, among the most prominent of which obstacles is the existence of market power. "Market power" is the ability of a supplier to impose on customers "a significant and nontransitory price increase on a product or service . . . above the price level which would prevail in a competitive market."⁷ In the Restructuring Act, the General Assembly authorized the Commission to address instances of market power that exist or develop within the Commonwealth. For instance, we may adjust the rates of any supplier whose prices exceed the price level that would prevail in a competitive market to the "extent necessary to protect retail customers from such market power."⁸

VNG owns and operates gas pipeline facilities that traverse the service territory of Virginia Power. The combination of

⁷ Section 56-576 of the Code of Virginia.

⁸ Section 56-578 G of the Code of Virginia.

VNG's control over natural gas pipeline facilities and Virginia Power's control over generating facilities in the same area would create a condition conducive to the existence of market power.

It is through such pipelines, indeed through this pipeline, that one of the essential ingredients for electric generation competition will arrive, i.e., the fuel necessary for the generation of reasonably priced electricity that can be produced in an environmentally responsible manner. The importance of the ability of competitive suppliers to access fuel through this facility in order to supply generation capacity within Virginia Power's territory cannot be overstated.

We believe, based on the evidence of record herein, that realization of meaningful electric competition in the Commonwealth could have been frustrated for a necessarily unknown, but probably considerable period, absent the agreement by the Petitioners to divest themselves of VNG. Prior to the filing of the Stipulation, we were faced with the choice of approving the merger, thus impeding the realization of competition, or rejecting the merger.

For these reasons, we believe the divestiture of VNG necessary to the development of effective electricity competition in the Commonwealth, and to avoid the impairment of adequate service at just and reasonable rates as a result of the merger.

Finally, the Stipulation requires that the Petitioners "sell and dispose of" VNG within one year of the completion of the merger, with reasonable extensions possible at the discretion of the Commission. Failing this action, paragraph 3 of the Stipulation requires certain other steps, the result of which would be that VNG is "spun-off" to the shareholders of DRI. In our view, compliance with the Stipulation can also be achieved by taking the actions contemplated by paragraph 3 during the earlier time period(s) allowed by paragraph 1. That is, we interpret paragraph 1 to require either a sale to a third party, or a "spin-off" to shareholders, in the manner required by paragraph 3 of the Stipulation.

State Jurisdiction

The merged company will be a registered holding company under the Public Utility Holding Company Act of 1935, a federal statute. Several paragraphs of the Stipulation recognize that this status may pose a risk of preemption of state law. Further, paragraph 9 of the Stipulation states:

The Petitioners, Virginia Power and VNG and their affiliates shall bear the full risk of any preemptive effects of the 1935 Act. The Petitioners, Virginia Power and VNG and their affiliates shall take all such actions as the Commission finds are necessary and appropriate to hold Virginia ratepayers harmless from rate increases, or foregone opportunities for rate decreases. Such actions may include, but are not limited to, filing with and obtaining approval from the SEC for such commitments as the Commission deems reasonably necessary to prevent such preemptive effects.

Moreover, paragraph 8 of the Stipulation states that "after the Proposed Merger, the Commission will have the same ratemaking and regulatory authority to regulate the rates and services of VNG and Virginia Power as it did before the Proposed Merger."

Upon analysis of PUHCA and cases decided thereunder, we find that certain conditions contemplated by the Stipulation are necessary to prevent this transaction from leading to possible federal preemption of state law. Such preemption would render the Commission unable to protect Virginia ratepayers from "rate increases, or foregone opportunities for rate decreases." To minimize the risk of such preemption, and to assure that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized," we find it necessary to condition our approval of the Joint Petition as set forth below.

Conditions

I.

Petitioners, Virginia Power and VNG⁹ shall have the following continuing obligations:

- (A) With respect to any contract that is subject to Section 12 or 13 of the Public Utility Holding Company Act of 1935:
 - (i) Neither Virginia Power, VNG, nor any other DRI affiliate subject to Virginia Commission regulation, shall enter into such contract without first obtaining an order from this Commission approving such action.

⁹ All conditions will continue in force as to VNG only until such time as its divestiture from the Petitioners is completed, except as otherwise required by law.

- (ii) Any such contract shall contain language providing that neither Virginia Power, VNG, nor such affiliate shall have any obligation under such contract except to the extent this Commission has approved such obligation.
- (B) Neither Virginia Power nor VNG shall transfer, or commit to transfer, to any affiliate or nonaffiliate, the control or ownership of any asset or portion thereof used for the generation, transmission, distribution or other provision of electric power and/or service or gas supply and/or service to customers in Virginia, without first obtaining all approvals from the Commission that are required by state law.
- (C) Neither Petitioners, VNG nor Virginia Power shall assert in any forum that DRI's status as a registered holding company under PUHCA preempts Virginia law, including Virginia law relating to the transfer of utility assets, the determination of appropriate capital and corporate structure, and the establishment of retail rates. Should any other entity so assert, the Petitioners, VNG and Virginia Power shall, unless otherwise directed by the Commission, oppose such assertions.¹⁰

II.

The Petitioners shall amend their merger application filed with the SEC to advise the SEC that they have agreed before the Virginia State Corporation Commission to abide by the continuing obligations set out as Part A and Part B of Condition I.

III.

The Commission must determine that any orders of the SEC approving the Petitioners' merger application are not inconsistent with this Order.

These conditions are necessary because of issues inherent in PUHCA and our joint state-federal system of regulation. A federal court has found that where a utility affiliate of a

¹⁰ Part C of Condition I applies the parties' commitment contained in paragraph 12 of the Stipulation to PUHCA issues.

registered holding company is a party to an inter-affiliate contract subject to PUHCA, the wholesale electric rates established for that utility must reflect the terms of that contract.¹¹ This decision creates a risk for Virginia: If Virginia Power or VNG were to pay an excess amount for goods and services purchased under an inter-affiliate contract, or receive an insufficient amount for items sold, current state law requiring appropriate adjustments to ensure just and reasonable rates might be preempted.

Since the problem described above arises from contracts filed by a utility with the SEC, Condition I A requires that the Virginia utility affiliate obtain our permission before entering into an inter-affiliate contract, and further requires that the contract itself include a related limitation on the utility's obligations. Virginia utilities consequently would be obligated

¹¹ In Ohio Power Company v. FERC, 954 F.2d 779 (D.C. Cir.), cert. denied, 506 U.S. 981 (1992), the U.S. Court of Appeals interpreted PUHCA to preclude FERC from disallowing, from Ohio Power's wholesale rates, charges paid for coal by the utility to its subsidiary, Southern Ohio Coal Company ("SOCCO"), under an inter-affiliate contract which was subject to PUHCA Section 13. The Court found that the FERC disallowance impermissibly produced "trapped costs," and explained: "By declaring a portion of the SOCCO coal price unreasonable and therefore not includable in Ohio Power's wholesale rate, FERC is undeniably affecting the economic relationship between Ohio Power and SOCCO, a relationship approved by, and under the jurisdiction of, the SEC." Ohio Power, supra at 784. The Court of Appeals also stated: "To the extent there is downward flexibility in a cost-based price, we find that Congress did not make room for anyone other than the SEC to exercise this flexibility." Ohio Power, supra at 785 (Emphasis added).

Although the Ohio Power decision involved federal and not state ratemaking, the Court cited and based its reasoning on Nantahala Power & Light v. Thornburg, 476 U.S. 953, 971 (1986), which found preemption of state ratemaking. Ohio Power, supra at 784 (quoting Nantahala, supra, 476 U.S. at 971). Moreover, the Court's phrase "anyone other than the SEC" implies

under those contracts only to the extent that we have determined that their contractual obligations are consistent with their state law requirement to charge just and reasonable rates.

We have applied this condition to inter-affiliate transactions subject to PUHCA Section 12 (financial transactions, such as inter-affiliate loans) and PUHCA Section 13 (sales of goods and services). Both types of transactions can affect the utility's costs and therefore its retail rates.

The Petitioners have agreed in the Stipulation that the Commonwealth's authority over their inter-affiliate activities should not be altered as a result of their new status under PUHCA. The conditions imposed herein with respect to inter-affiliate transactions will carry out the parties' intent that the same state law requirements to which they and all other utilities in Virginia have long conformed, i.e., Chapters 3 and 4 of Title 56 of the Code of Virginia, will continue in force.

A similar concern arises as to the Commonwealth's continuing jurisdiction over the transfer of utility assets, a matter over which the state has long exercised supervisory authority. As a result of the Restructuring Act, the Commission will be faced with important new issues concerning Virginia

that its reasoning would preclude not only FERC ratemaking but state ratemaking.

Power's assets. Specifically, § 56-590 requires the Commission to review and condition the utility's plan for functional separation. Also, § 56-579, as well as the Utility Transfers Act,¹² requires the Commission to review and approve proposals to transfer control or ownership of transmission facilities and/or other assets.

These provisions are vital to carrying out the General Assembly's goal of retail electricity competition. The Commission therefore must protect against the possibility that DRI's new registered status under PUHCA will preempt these statutes. The conditions set forth above seek to achieve this protection. In addition to preserving state law authority over utility affiliate transactions and utility asset transfers, these conditions are necessary to ensure that "adequate service to the public at just and reasonable rates is not impaired or jeopardized."

The parties have expressed that they intended no change in the Commission's regulatory authority over the rates and services of Virginia Power and VNG as a result of the merger. Such status quo could not be maintained if the Commission were to lose its existing authority over the critical assets and organizational structures utilities use in providing public service. As we stated with regard to inter-affiliate transactions, the conditions imposed herein with respect to

¹² Section 56-88 et seq. of the Code of Virginia.

utility asset transfers effectuate the parties' intent that the same state law requirements to which they and all other utilities in Virginia have long conformed, i.e., Chapter 5 of Title 56 of the Code of Virginia, will continue in force. These conditions will also preserve the Commonwealth's authority under the new Restructuring Act.

Paragraph 10 of the Stipulation contains a provision whereby "if the Commission does not intend to approve all aspects of this Stipulation," we are requested to notify the parties and allow a brief period of further negotiation. Failing acceptable agreement, we would convene a hearing at the request of any of the parties to the Stipulation. The conditions we have imposed do not add to those of the Stipulation or modify it in any substantive manner. These conditions have their genesis in the provisions of the Stipulation, including particularly paragraph 9. The conditions make the protections of the Stipulation more precise and more responsive to the specific issues that concern us.

We therefore see no occasion for the above provisions of paragraph 10 to operate. If, however, the parties disagree with respect to this conclusion or any other aspect of this Order, they can of course, file a petition for reconsideration.

Conclusion

In conclusion, we find that, as a result of the assurances and undertakings contained in the Stipulation and subject to the

conditions set out in this Order, the Joint Petition complies with the statutory standards established in § 56-90 of the Code of Virginia; is in the public interest; will not cause adequate service to the public at just and reasonable rates to be impaired or jeopardized; and so should be, and is, approved.

Accordingly, IT IS ORDERED THAT:

(1) The Motion to Withdraw Comments, Notice of Protest and Interrogatories, filed by the Coops, is GRANTED.

(2) The requested acquisition is APPROVED, subject to the terms and conditions of this Order; however, the Petitioners may not consummate the merger until such time as the Commission has issued its determination that the orders of the SEC approving the Petitioners' merger are not inconsistent with this Order.

(3) Petitioners shall file copies of said SEC orders with the Commission within 10 days of their receipt of same. Within 30 days thereafter, the Commission shall issue its determination pursuant to Paragraph (2) above.

(4) The Stipulation is adopted in full herein and the Petitioners, VNG and Virginia Power are ORDERED to comply with its terms and with the conditions established in this Order.

(5) The public hearing scheduled in the matter is CANCELLED, for the reasons set out herein.

(6) This Order shall have no ratemaking implications.

(7) This matter is continued for further order of the Commission.